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The Honorable Chairman Tiber
House Ways and Means Committee
Via email, only

Regarding Tax Reform and Foreign Investment in the United States

Dear Honorable Chairman Tiberi
and other members of the House
Ways and Means Committee:

Thank you for this opportunity to provide my written comments on tax reform of foreign direct investments in the United States of America.

As a certified public accountant with a public accounting practice concentrating on helping cross border privately owned businesses, I am concerned by the prejudice against foreign direct investments found in the Internal Revenue Code ("IRC").

These prejudices manifest themselves in three areas.
They are:

Discriminatory Strict Laws Forcing Double Taxation
aka "BRANCH PROFITS TAX"

Enacted in 1986, the branch profits tax was modeled after the domestic accumulated earnings and profits tax, section 531.

Only the foreign business is subject to the strict double taxation rules (explained below) of the branch profits tax. In both the friendship, navigation and commerce treaties and tax treaties America promise not to discriminate against the foreign business. Yet, in practice, America does discriminate, as I will explain below.

Section 531 and the concept of double taxation of privately owned business have their genesis in the 1954 IRC. Changes in the IRC allowing Subchapter S corporations and single member limited liability companies have made section 531 irrelevant. Because of section 531, rarely does small business select corporation taxation under Subchapter

C[1].

The regulations for section 531 allows profits to be accumulated for reasonable needs of the business, redemption of shareholders and the sophisticated model (known as the "Bardahl Formula") that allows a practical accumulation of profits for business operations.

The stated purpose of the branch profits tax was to bring about a similar tax treatment of foreign corporations engaged in a United States business with domestic corporations. Further Congress and the Senate wanted to promote neutrality by subjecting the U.S. branch earnings of a foreign corporation to a second level of U.S. tax upon a "deemed remittance."

As you will discover no real remittance to a foreign home office is required for the tax to apply. Merely the accumulation of profits beyond what the IRS deems reasonable causes the tax to be assessed. The IRS makes this determination using the IRS' hindsight. In writing the branch profits tax regulations, the IRS could have included the exceptions found in section 531. However, the branch profit tax income regulations exclude all of the rules found in the section 531 regulations.

Instead regulation 1.884-1(d)(2)(v) provides the IRS the authority to deem that a remittance occurred. The regulation removes any bank deposit from the definition of a branch asset with the following text- "Any other deposit or credit balance shall only be treated as a U.S. asset if the deposit or credit balance is *needed*[2] in a U.S. trade or business within the meaning of section 1.864-4(c)(2)(iii)(a)."

Unlike section 531, the branch profit tax refers to a regulation (1.864-4) that is not related to the reasonable needs of a business to accumulated working capital. Regulation 1.864-4 determines the source of income and not the reasonable needs of a business to accumulate working capital.

The assumptions used by Congress and the Senate in 1986 no longer exist. Privately owned domestic businesses do not incur double taxation. They operate as either sole proprietorships or as pass-through entities. They choose this method not only to avoid double taxation but just as importantly to avoid the overly complex tax law of Subchapter C.

Publically owned businesses rarely incur double taxation. The average dividend rate of the Standard and Poor's 500 corporations is approximately two percent. Section 531 has never been applied to a corporation listed on the major American stock exchanges.

Further the branch profits tax applies to the foreign corporation with a branch office in America or owning a partnership share (which includes ownership in a domestic limited

[1] An exception is a "loan out" corporation. However, loan out corporations zero out their taxable income with a combination of compensation, qualified retirement plan contributions and medical benefits.

[2] Emphasis added by author.

liability company). Where the foreign corporation makes the United States its headquarters, the owners are shocked to discover the branch profits tax applies even though there is no foreign activity and all of the activity is in America.

Section 884 consists of three main parts:
1. Branch profits tax on certain earnings of a foreign corporation's U.S. trade or business,
2. Branch-level interest tax on interest paid, or deemed paid, by a foreign corporation's U.S. trade or business and
3. An anti-treaty shopping rule

A foreign corporation is subject to Section 884 by virtue of owning an interest in a partnership, trust, or estate that is engaged in a U.S. trade or business or has income treated as effectively connected with the conduct of a trade or business in the United States ("ECI").[3]

(1) The branch profits tax

Section 1.884-1 provides rules for computing the branch profits tax and defines various terms that affect the computation of the tax. In general, Section 884(a) imposes a 30 percent branch profits tax on the after-tax earnings of a foreign corporation's U.S. trade or business that are not "deemed" reinvested in a U.S. trade or business by the close of the taxable year, or that are "deemed" disinvested in a later taxable year.

Changes in the value of the equity of the foreign corporation's U.S. trade or business are used as the measure of whether earnings are deemed reinvested in, or disinvested from, a U.S. trade or business. An increase in the equity during the taxable year is generally treated as a reinvestment of the earnings for the current taxable year; a decrease in the equity during the taxable year is generally treated as a disinvestment of prior years' earnings that have not previously been subject to the branch profits tax.

The amount subject to the branch profits tax for the taxable year is the dividend equivalent amount. This amount is the reduction in the net worth of the U.S. branch. Form 1120F includes a place for the computation of the reduction of the net worth. One may feel that by merely keeping all of the net profits on the U.S. branch in America, one can avoid the tax on the dividend equivalent. However, American tax law looks at why assets are kept in the branch. If a foreign corporation cannot prove that the assets are in the branch for an active business reason, then the dividend equivalent tax applies.

The tax rate is 30 percent unless reduced by tax treaty.

Section 1.884-2 contains special rules relating to the effect on the branch profits tax upon the termination or incorporation of a U.S. trade or business, or the liquidation or reorganization of a foreign corporation or its domestic subsidiary. In theory, the tax

[3] An international organization (as defined in Section 7701(a)(18)) is not subject to the branch profits tax by reason of Section 884(e)(5). A foreign government treated as a corporate resident of its country of residence under Section 892(a)(3) shall be treated as a corporation for the purposes of Section 884. In the case of branch interest, Section 884 applies only with respect to amounts of interest accrued and paid by a foreign government on or after that date, or, in the case of excess interest, only with respect to amounts attributable to interest accrued by a foreign government on or after that date and apportioned to ECI, as defined in Section 1.884-1(d)(1)(iii).

does not apply. However, as explained below, this regulation has many esoteric and overly complex exceptions that create taxation.

(2) The branch-level interest tax.

Section 1.884-4 provides rules for computing the branch-level interest tax. In general, interest paid by a U.S. trade or business of a foreign corporation ("branch interest," as defined in Section 1.884-4(b)) is treated as if it was paid by a domestic corporation and may be subject to tax under Section 871(a) or 881, and to withholding under Section 1441 or 1442. In addition, if the interest apportioned to ECI exceeds branch interest, the excess is treated as interest paid to the foreign corporation by a wholly owned domestic corporation and is subject to tax under Section 881(a).

This overly complex law is a surprise attack on the privately owned foreign direct investment. International financing is desirable in most other countries except for America.

(3) Anti-Treaty Shopping

Section 1.884-5 contains anti-treaty shopping rules. The concept is that the foreign entity must pay tax to the treaty jurisdiction and must be owned by residents of the treaty jurisdiction. The term “qualified resident” is used to designate such a person. A foreign corporation must be a qualified resident of a foreign country with which the United States has an income tax treaty in order to claim an exemption or rate reduction with respect to the branch profits tax, the branch-level interest tax, and the tax on dividends paid by the foreign corporation.

The Double Whammy - Regulation Section 1.864-4’s Example 4

The IRC not only taxes the foreign person on its U.S. business, it taxes on its income attributed to its foreign offices. This is income is taxed not just once by the United States, but twice.

Read this example from the regulations.

“Foreign corporation S, which uses the calendar year as the taxable year, is engaged in the business of purchasing and selling electronic equipment. The home office of such corporation is also engaged in the business of purchasing and selling vintage wines.”

“During 1968, S establishes a branch office in the United States to sell electronic equipment to customers, some of whom are located in the United States and the balance, in foreign countries. This branch office is not equipped to sell, and does not participate in sales of, wine purchased by the home office. Negotiations for the sales of the electronic equipment take place in the United States. By reason of the activity of its branch office in the United States, S is engaged in business in the United States during 1968.”

“As a result of advertisements which the home office of S places in periodicals sold in the United States, customers in the United States frequently place orders for the purchase of wines with the home office in the foreign country, and the home office makes sales of wine in 1968 directly to such customers without routing the transactions through its branch office in the United States.”

“The income or loss from sources within the United States for 1968 from sales of electronic equipment by the branch office, together with the income or loss from sources within the United States for that year **from sales of wine by the home office**, is treated as effectively connected for that year with the conduct of a business in the United States by S.”

A successful foreign business is not going to subject their foreign home office’s sales to both U.S. income and U.S. branch profits tax totaling sixty-five percent (plus a state income tax) by making a foreign direct investment.

REGULATORY SHORT COMINGS

Businesses flee uncertainty, especially when the uncertainty is a thirty percent discriminatory tax that does not apply to its domestic competition. This tax destroys working capital. Without working capital, a business ceases to be a going concern.

The regulations fall short in providing guidance based upon the comparable domestic law, section 531. The consequence of the absence of a regulation providing the benefits found in section 531 is that reasonable taxation rules of section 531 are not available. The branch profits tax becomes an off or on switch tax law that only applies to foreign corporations.

Further, complexity surrounds the termination of a United States branch. Regulation section 1.884-2 explains the termination rules. Every business needs to know its exit plan. Uncertainty as to the exit plan can prevent a foreign direct investment. The concepts found in this regulation are overly complex and esoteric.

Here are some of the paragraph headings relating to the ending of a U.S. business by a foreign corporation: “Property subject to reinvestment prohibition rule”, “Direct or indirect use of U.S. assets”, “Complete termination in the case of a section 338 election”, “Coordination with second-level withholding tax”[4], “Transferor's dividend equivalent amount for the taxable year in which a section 381(a) transaction occurs”, “Special rules in the case of the disposition of stock or securities in a domestic transferee or in the transferor”, “Inapplicability of paragraph (a)(1) of this section to section 351 transactions, Transferor's dividend equivalent amount for the taxable year in which a section 351 transaction occurs”, “Amount of the transferor's effectively connected earnings” and “Profits and non-previously taxed accumulated effectively connected earnings and profits allocated to the transferee” and “Certain transactions with respect to a domestic subsidiary”.

CONFISCATORY ESTATE TAXES ON THE OWNERS OF FOREIGN DIRECT INVESTMENTS

Foreign direct investments by non-publically traded corporations expose the investor to a confiscatory estate tax. The non-domiciled alien has an estate tax exemption valued at $60,000.

The non-domiciled alien is also subject to gift tax and generation skipping tax with a limited annual deduction and without the five million dollar exclusion.

The non-domiciled alien does not have the unlimited marital deduction.

[4] By the way, there is to be no second level withholding when the branch profit tax applies or has applied.

Investments in United States property are included in the taxable estate of a nondomicile. Until a few years ago, tax professionals believed that the ownership of shares of a foreign corporation by a non-domicile alien was exempt from United States estate taxes.

However, since the series of tax court decisions—*Strangi, Albert, Estate of et al. v. Comm.* (05-20-2003); *Bongard, Wayne C., Estate of v. Comm.* (03-15-2005); *Stone, Eugene E., Estate of III, et al. v*. Comm. (11-07-2003); *Harper, Morton B., Estate of v. Comm.* (05-15-2002); and *Kelley, Webster E., Estate of et al. v. Comm.* (10-11-2005)—this is no longer the belief.

In these cases, the court ruled that IRC Section 2036 requires that assets held by any entity be included in the taxable estate of any decedent who transferred property to the entity. Under Section 2036, the property transferred is included in the decedent's taxable estate when he or she retained the right to the income.

The foreign investor owning all or substantially all of the stock of a foreign corporation is considered to own the corporate assets under section 2036 (retained life estates). Under the case law, stock owned by a family subjects each person to estate tax inclusion under section 2036. In these cases, as in most family business, the family planned to withdraw the profits of the business for personal use and enjoyment.

Section 2036 specially covers the use and/or enjoyment of property.

CONCLUSION

The IRC makes doing business in the United States undesirable when compared to countries such as the United Kingdom, Switzerland[5] and The Netherlands in Europe and Singapore and Honk Kong in Asia.

Each of these other countries does not subject the foreign person to a confiscatory estate tax and double taxation on the successful foreign direct business. Further, the branch profits tax law on a business termination is so overly complex and unclear, that the foreign investor cannot determine his tax upon leaving the United States.

The cost of United States tax administration and a sixty five percent tax rate discourages direct foreign investment.

Respectfully submitted,

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[5] For example, from 2004 to 2006 more than 1,000 foreign companies moved to Switzerland (on this link), a country with a population of less than eight million people.